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No. 02-1196

IN THE

Supreme Court of the United States

SECURITIES AND EXCHANGE COMMISSION,
Petitioner,

v.

CHARLES E. EDWARDS,
Respondent.

On a Writ of Certiorari to the United States Court of Appeals for the Eleventh Circuit

BRIEF OF THE NORTH AMERICAN SECURITIES ADMINISTRATORS ASSOCIATION, INC., AS *AMICUS CURIAE*, IN SUPPORT OF THE SECURITIES AND EXCHANGE COMMISSION

MARK J. DAVIS *
Associate Counsel
JOHN R. VEATOR
Deputy General Counsel
STEPHEN W. HALL
Associate Counsel
NORTH AMERICAN SECURITIES ADMINISTRATORS ASSOCIATION, INC.
10 G Street, N.E., Suite 710
Washington, D.C. 20002
(202) 737-0900

* Counsel of Record

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WILSON-EPES PRINTING CO., INC. – (202) 789-0096 – WASHINGTON, D. C. 20001

QUESTIONS PRESENTED

1. Whether a return on an investment should be excluded from the meaning of "profits" under the *Howey* test for investment contracts merely because the promoter of the investment offers a fixed rate of return.

2. Whether a return on an investment, which is in fact wholly dependent upon the efforts of others, should nevertheless be viewed as not "derived from the efforts of others" under *Howey* merely because the promoter contractually promises or guarantees the return.

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BRIEF OF THE NORTH AMERICAN SECURITIES ADMINISTRATORS ASSOCIATION, INC., AS *AMICUS CURIAE*, IN SUPPORT OF THE SECURITIES AND EXCHANGE COMMISSION

INTEREST OF THE *AMICUS CURIAE*

The North American Securities Administrators Association, Inc. ("NASAA"), is the nonprofit association of the state, provincial, and territorial securities regulators in the United States, Canada, and Mexico. It has 66 members, including the securities regulators in all 50 states, the District of Columbia, and Puerto Rico. Formed in 1919, it is the oldest international organization devoted to the protection of investors in securities.[1]

[1] Pursuant to Sup. Ct. R. 37.6, NASAA represents that no counsel for any party authored this brief in whole or in part, and no person or entity,

The members of NASAA are responsible for administering state securities laws and regulations. Their principal activities include licensing, registration, enforcement, and investor education. State securities regulators also strive to increase uniformity in the securities laws, as enacted and as interpreted. NASAA supports the work of its members in all of these endeavors, for the ultimate purpose of protecting investors from fraud and abuse.

The Eleventh Circuit's decision in this case, holding that ETS pay phone investments are not securities, undermines investor protection on several levels. First, it removes the protections of federal securities regulation from pay phone investment contracts, which are notorious vehicles for fraud and abuse. Although it is to be expected that state regulation of these investments will continue, eliminating the SEC's jurisdiction over such offerings will at a minimum increase the burden on state regulators and heighten the risk that investors will fall victim to these schemes. NASAA therefore has an interest in seeking the reversal of the appellate court's decision and the restoration of federal regulation of these products.

Second, the appellate court's decision substantially narrows the federal definition of "investment contract" under *SEC v. W.J. Howey Co.*, 328 U.S. 293 (1946). The Eleventh Circuit held that investments offering either fixed or contractually guaranteed returns do not qualify as investment contracts. This unsupported interpretation of *Howey* creates loopholes that unscrupulous promoters undoubtedly will seek to exploit in the future as they invent new ways to defraud the investing public. NASAA has an interest in helping to

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other than NASAA, its members, or its counsel, made any monetary contribution to the preparation or submission of the brief. Pursuant to Sup. Ct. R. 37.3, NASAA further represents that both parties to this appeal consented to the filing of this *amicus* brief. Copies of their written consents are being filed with this brief.

prevent this potentially far-reaching impact of the appellate court's decision.

Finally, the appellate court has set a precedent that, if affirmed by this Court, will profoundly and adversely affect the evolution of state securities law to the detriment of investors. State courts and administrative agencies often look to federal decisions for guidance on issues common to state and federal securities law. NASAA has an interest in helping to ensure that the appellate court's decision does not weaken state securities law in this way.

SUMMARY OF THE ARGUMENT

The appellate court's decision should be reversed for two reasons. First, the narrow interpretation of *Howey* adopted by the Eleventh Circuit will harm investors. If affirmed, the ruling will expose thousands of everyday citizens throughout the country to a heightened risk of fraud and abuse at the hands of pay phone promoters and others selling a variety of sale and leaseback investments no longer subject to federal regulation as securities. More broadly, the decision provides an unfortunate blueprint to unscrupulous promoters who easily will devise new schemes that fall outside the appellate court's narrow definition of an investment contract. In its most far-reaching impact, the decision will have a corrosive effect not only on federal securities law, but on state securities law as well. Federal courts in general exert an important influence over state courts and administrative tribunals in the area of securities regulation, and the decisions of this Court have by far the greatest impact. It is therefore essential that this Court reject the appellate court's decision so that state securities law is not undermined.

Second, the appellate court's decision should be reversed because it is legally untenable. The ruling conflicts with the plain meaning and intent of the securities laws, the vast weight of federal and state court decisions, and long-standing

administrative agency interpretation. There is no persuasive rationale for the Eleventh Circuit's narrow construction of the term "investment contract," nor is there any reason for excusing Edwards or any similar promoter from complying with the licensing, registration, and disclosure requirements imposed under the securities laws. Unless the pay phone investments at issue in this case continue to be fully regulated as securities at both the federal and state level, investors will suffer. Accordingly, the Eleventh Circuit's decision should be reversed.

ARGUMENT

I. THE APPELLATE COURT'S DECISION OPENS AN ENORMOUS LOOPHOLE IN SECURITIES LAW, WHICH EXPOSES INVESTORS TO A HEIGHTENED RISK OF FRAUD AND ABUSE

By holding that the ETS pay phone investment is not a security, the appellate court has placed investors at risk. Over the past decade, there have been widespread abuses in the marketing of pay phone schemes, and as a consequence, thousands of investors have lost money. Continued regulation of these and similar products under both federal and state securities law is essential to limit the financial harm they inflict upon investors.

A. Scope of the Problem

The pattern of abuses in the marketing of pay phone sale and leaseback programs is well documented. Over the years, state securities regulators across the country have initiated scores of administrative and civil actions against pay phone sale and leaseback companies and their agents, including ETS, Alpha Telcom, Phoenix Telecom, QCI, and others.[2]

[2] The investments sold by these companies are essentially the same. Alpha Telcom offered investors 30% of adjusted gross revenues, but with a guaranteed minimum that equated to a 14% return. *See, e.g., In re Alpha Telcom,* No. 99-07-0220, 2002 WL 459704, *3 (Wash. Sec. Div. Mar. 13, 2002).

The record in this case, for example, includes three cease and desist orders issued against ETS by state securities regulators in Kansas, North Carolina, and Rhode Island, all arising from the sale of unregistered securities and, in the action by North Carolina, fraudulent sales practices as well. *See* Exs. 9, 10, 11. Other cases abound.[3]

The scope of the problem was highlighted in March 2001, when NASAA announced the results of a crackdown by securities regulators in 25 states and the District of Columbia against individuals and companies selling pay phone sale and leaseback investments in violation of state securities law. *See* NASAA, *State Securities Cops Announce Actions Against Sellers of Payphone Schemes; Losses Estimated at $76 Million So Far,* March 13, 2001, *available at* www.nasaa.org, "Archived Top Stories." Nearly 4,500 people, most of them elderly, were reported to have lost $76 million investing in these schemes, which were described as "the tip of a very large iceberg." *Id.* As a further part of its continuing effort to warn the investing public about illegal and fraudulent investments, NASAA repeatedly has included sale and

[3] A sampling of enforcement actions against pay phone programs includes the following cases, in addition to the actions discussed elsewhere in the brief: *In re Sommer,* No. S-03489A-03-0000 (Ariz. Corp. Comm'n Feb. 25, 2003), *available at* http://www.ccsd.cc.state.az.us/enforcement/Actions/2003/feb25-03.pdf; *In re Nat'l Communics. Mktg., Inc.*, No. A-02-0037 (Ore. Div. of Fin. & Corp. Secs. Oct. 2002); *In re Fecht*, No. 02-12, 2002 WL 927153 (Tx. St. Sec. Bd. Apr. 24, 2002); *In re Alpha Telcom, Inc.,* No. 01-36-S, 2001 WL 1650906 (Ark. Sec. Dep't Sept. 5, 2001); *In re Nat'l Communics. Mktg., Inc.,* No. 99-06-0176, 2001 WL 236889 (Wash. Sec. Div. Feb. 26, 2001); *Dep't of Banking & Fin. v. Paytel Communic. Sys., Inc.,* No. 98-1626, 2000 WL 347485 (Fla. Div. of Admin. Hr'gs Mar. 16, 2000); *In re Alpha Telcom, Inc.,* No. S-99225 (EX), 1999 WL 1083919 (Wisc. Comm'r of Sec. Nov. 24, 1999); *In re Phoenix Telecom LLC,* No. 2-16-99-038 (Mont. Sec. Dep't Oct. 29, 1999).

leaseback schemes in its annual review of the "Top 10" scams to be avoided. *See* NASAA, *"Top 10" Investment Scams Listed by State Securities Regulators"* (Aug. 26, 2002; Apr. 23, 2001), *available at* www.nasaa.org, "News and Public Affairs."

The U.S. Securities and Exchange Commission (SEC) also has taken aggressive enforcement action against these illegal enterprises. Examples include this case against ETS as well as four injunctive actions in federal district court in Florida and Georgia, in which the SEC sought millions of dollars in disgorgement and other relief against four pay phone companies and their agents. *SEC v. Phoenix Telecom,* No. 100-CV-1970-JTC (N.D. Ga.), 2001 WL 874314 (SEC Release No. 17089, Aug. 3, 2001); *SEC v. Linktel Communics., Inc.*, No. 100-CV-3169-WBH (N.D. Ga.), 2000 WL 1773106 (SEC Release No. 16816, Dec. 4, 2000); *SEC v. Levine*, No. 94-6898-CIV-ZLOCH (S.D. Fla.), 1994 WL 559076 (SEC Release No. 14279, Sept. 30, 1994); *SEC v. Haje*, No. 92-510-CIV-J20 (M.D. Fla.), 1993 WL 347148 (SEC Release No. 13772, Sept. 3, 1993).

The violations common to these operations include the sale of unregistered securities in the form of investment contracts by unlicensed agents making fraudulent misrepresentations and omissions concerning the risk of loss, the likelihood of profits, the financial condition of the enterprise, and the promoter's disciplinary history. *See generally SEC v. Alpha Telcom, Inc.,* No. CV 01-1283 PA, 2002 WL 193093 (D. Or. Feb. 7, 2002); *SEC v. Phoenix Telecom, L.L.C.,* No. 1:00-CV-1970-JTC, 2000 WL 33956119 (N.D. Ga. Aug. 2, 2000).

These violations of the securities laws have caused enormous financial injury to public investors. An enforcement action brought by the state securities regulator in Florida against two individuals who sold the ETS program illustrates the point. *See Dep't of Banking & Fin. v. Mehl,* No. 02-0526, 2002 WL 31452438, at *24-25 (Fla. Div. Admin. Hr'gs

July 16, 2002) (Recommended Order), *aff'd, Dep't of Banking & Fin. v. Mehl,* No. 02-0526, 2002 WL 31452438 (Fla. Dep't of Banking & Fin. Oct. 17, 2002) (Final Order). The administrative law judge in *Mehl* concluded that the ETS pay phone program was an investment contract, bearing "all the indicia of a Ponzi scheme," which the respondents had sold, along with other illegal offerings, in violation of the licensing and registrations provisions of the Florida securities act. *Id.* at *16, 22-24. The ALJ imposed multi-million dollar fines against each of the respondents, with this observation: "These fines are fair for the enormity of the harm caused by Respondents in this case. Even if acting only negligently, Respondents have left many persons in irreversible financial ruin for the remaining years of their lives." *Id.* at *24.

B. Benefits of Regulation

The SEC and state securities regulators have long viewed pay phone sale and leaseback schemes as securities and have regulated them as such. Accordingly, investors have been receiving important protections as intended by Congress and the state legislatures. First, the securities themselves must be registered so that material information about the offering is made available to prospective investors before they part with their money. *See* 15 U.S.C. §§ 77f, 77g, 77j; Unif. Sec. Act of 1956 § 301 (registration of securities); *see also In re Nat'l Communics. Mktg., Inc.,* No. 99E039 (Ka. Sept. 25, 1998) (Cease and Desist Order), Ex. 10, at 5 (due to lack of registration, Kansas residents are not provided with the investment information required by the Kansas Securities Act).[4] Second, those who sell securities must be tested and

[4] The Uniform Securities Act of 1956 is the predominant model for states securities laws. It has been adopted by 34 states, with some individual variations. *See* Chart showing states adopting Unif. Sec. Act of 1956, *available at* www.law.cornell.edu/uniform/vol7.html#secur. Even those states that have passed their own securities laws have similar regulatory requirements and remedies.

licensed to help ensure they have the knowledge and fitness to accept investor funds and render investment advice. *See* 15 U.S.C. § 78o; Unif. Sec. Act of 1956 § 201 (licensing of industry participants); *see also In re Communics. Mktg. Assocs., Inc,* NO. DBR 00-114 (R.I. Mar. 28, 2000) (Cease and Desist Order), Ex. 11 at 3 (respondent's failure to be licensed exacerbates likelihood that untrained, inexperienced salespersons will defraud or take advantage of investors).

Third, the securities laws impose stiff civil and criminal penalties as a deterrent against violations of the licensing, registration, and anti-fraud provisions. *See* 15 U.S.C. §§ 77q, 77t, 77x, 78f, 78j, 78u; Unif. Sec. Act of 1956 §§ 101, 408-410 (civil and criminal penalties). Finally, the securities laws give regulators the authority to seek important remedial measures, including injunctions, disgorgement, and restitution. *See id.* (injunctive relief and civil liabilities); *see also In re ETS Payphones, Inc.,* No. 01-0056CD, 2002 WL 1586379, at *1 (Ind. Sec. Div. June 7, 2002) (ETS salesman ordered to disgorge commissions to injured investor pursuant to consent agreement).

With these requirements and remedies at their disposal, regulators can deter violations in the first instance, enjoin violations in progress, and attempt to recover ill-gotten gains from those who have profited at the expense of investors. All of these provisions have played an important role in limiting the harm that illegal pay phone schemes and other investment contracts have inflicted on the investing public.

C. Future Impact

The appellate court's decision in this case threatens harm to investors on multiple levels by stripping away these protections. If allowed to stand, the decision's most immediate impact will be to tie the SEC's hands with respect to pay phone sale and leaseback programs, as well as all other investment contracts that have been structured to provide

fixed or guaranteed returns.[5] While indications are that state securities regulators will continue to enforce their laws against promoters of these products, sidelining the SEC will increase the burden on these state regulators and inevitably expose investors to a heightened risk of fraud and abuse.

The appellate court's decision also threatens a much broader harm by fundamentally narrowing the application of the *Howey* investment contract test. "Guaranteed" and "fixed returns" often are meaningless labels that promoters attach to their investment contracts to attract investors. *See Dep't of Banking & Fin. v. Mehl,* No. 02-0526, 2002 WL 31452438 (Fla. Dep't of Banking & Fin. Oct. 17, 2002) (Final Order) (observing that the guarantee accompanying ETS contracts was "nothing more than the promoter's means of lulling the investor into a feeling of security and thereby parting him from his money"). Under the court's decision, these same terms—easily inserted into a contract—will serve as a convenient shield against regulation of investment contracts as securities. Regulators can now expect to see the emergence of a wide variety of new and fraudulent investment schemes specifically designed to benefit from the loophole created by the appellate court.

Finally, the court's decision will undermine state, as well as federal, securities regulation. State courts and state administrative agencies often consult federal decisions for guidance on securities issues. *See, e.g., Payable Accounting Corp. v. McKinley*, 667 P.2d 15, 17 (Utah 1983) (states frequently rely on federal case law in interpreting state securities acts). As observed by the Florida Department of

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[5] ATM machines and Internet kiosks are examples of other products that have been the subject of illegal investment schemes similar to the pay phone sale and leaseback programs. *See* NASAA, *"Top 10" Investment Scams Listed by State Securities Regulators"* (Aug. 26, 2002; Apr. 23, 2001), *available at* www.nasaa.org, "News and Public Affairs."

Banking and Finance, "In some instances, state and federal securities laws appear as mirror images. Both, for example, have the same definition for the term 'security.' For these reasons, in the absence of state decisional law, state courts will look to federal court decisions for guidance." *Dep't of Banking & Fin. v. Mehl*, 2002 WL 31452438, at *2. Some state securities laws expressly provide that their interpretation should be coordinated with the interpretation and administration of federal securities law. *See State v. Gertsch*, 49 P.3d 392, 396 (Idaho 2002).

The appellate court's decision has prompted numerous pay phone promoters to challenge prior rulings against them in state enforcement actions. These arguments have surfaced in states within the Eleventh Circuit and elsewhere. In *Iowa ex rel. Miller v. Pace*, Equity No. LA26445 (Iowa D. Ct., Warren County Sept. 4, 2002), *appeal docketed*, No. 02-1726 (Iowa, Oct. 28, 2002), the Iowa District Court found that ETS pay phone transactions were investment contracts under *Howey,* and ordered the defendant to make restitution of over $300,000 for fraud in the sale of unregistered securities. *Id.* at 16, 23-24, 27-28. The defendant has appealed the state district court's order to the Iowa Supreme Court, and is relying heavily on the Eleventh Circuit's opinion in this case for the proposition that the ETS offerings are not investment contracts as a matter of law. *See* Appellant's Proof Br. at 28-32, *Iowa ex rel. Miller v. Pace,* No. 02-1726 (Iowa Jan. 21, 2003). The appeal is pending.

In *Garvin v. Sec'y of State,* No. OSAH-SECSTATE-SECUR-0231234-33-PJ, at 1 (Ga. Off. of Admin. Hr'gs Aug. 28, 2002) (Order on Reconsideration), an administrative law judge with the Georgia Office of Administrative Hearings ruled that the ETS pay phone investment was a security, issued a cease and desist order against further offerings of the investment, and imposed a fine against the respondent for

selling unregistered securities. The respondent filed a petition for review in state court, relying in part on the Eleventh Circuit's opinion in this case. *See* Aff. of Charles R.T. O'Kelley, attached as Ex. B to Pet'r Br. in Support of Pet. for Judicial Review, at 7-8, *Garvin v. Sec'y of State,* No. 2002 CV 60273 (Ga. Super. Ct., Fulton County Dec. 16, 2002). On March 17, 2003, the Georgia Superior Court ruled against the respondent, expressly rejecting the Eleventh Circuit's analysis and affirming that the ETS program is an investment contract. *See Garvin v. Sec'y of State,* No. 2002 CV 60273 (Ga. Sup. Ct., Fulton County Mar. 17, 2003) (Final Order). However, on April 14, 2003, the respondent filed an application in the Georgia Court of Appeals for a discretionary appeal, relying again on the Eleventh Circuit's decision in this case. *See Garvin v. Sec'y of State,* No. 2002 CV 60273, Application No. A03D0309, at 17, 20 (Ga. Ct. App. Apr. 14, 2003). That application was granted on April 29, 2003, and the appeal is pending. *See id.* (Order Granting Applic. for Discr. App.).

The Eleventh Circuit's decision also has been cited in defense of investments other than pay phone sale and leaseback programs. In *In re Yucatan Resorts,* No. 2002-10-33, 2002 WL 31971658, at *1-2 (Pa. Sec. Comm'n Oct. 22, 2002) (Summary Order to Cease and Desist), the Pennsylvania Securities Commission named the respondents in a summary cease and desist order for selling unregistered securities in the form of a vacation resort leasing program. The program offered an annual return of 9%-11%, and featured the services of a third-party agent to handle leasing of the resort units for investors. *Id* at *1. On January 22, 2003, the respondents filed a request to vacate the order, and a motion for summary judgment in the alternative, relying in part on the Eleventh Circuit's ruling. *See* Resp't Req. to Vacate Cease and Desist Order or in the Alternative, Mot. for Summ. J. and Br. in Support Thereof, at 11-14, *In re Yucatan*

Resorts, No. 2002-10-33 (Pa. Sec. Comm'n Jan. 22, 2003). That request is pending.[6]

The influence of the Eleventh Circuit's decision has not been confined to courts and administrative agencies. Evidently as a direct result of the court's ruling, a bill was introduced in the Colorado legislature that would have amended the definition of a security in that state to *exclude* leaseback arrangements involving "a contractually fixed and guaranteed rate of return." *See* House Bill 1311, 1st Sess. (Colo. 2003).[7] This bill is particularly significant because Colorado is among the states where both state and federal regulators have taken aggressive enforcement action against pay phone promoters. *See Joseph v. Geier,* No. 01 CV 1151 (Colo. D. Ct., Denver County Jan. 30, 2003) (Order on Motions for Summary Judgment) (Phoenix Telecom pay phone program held to be investment contract); *SEC v. Quarter Call, Inc.,* No. 94Z-1227 (D. Colo.), 1996 WL 635380 (SEC Release No. 15145, Nov. 4, 1996) (action against now bankrupt pay phone company QCI, finding that defendants obtained over $9 million from 520 investors in fraudulent sales of pay phone investments). Although the bill did not become law, it nevertheless was a

[6] On May 2, 2003, the Pennsylvania Securities Commission was forced to seek a preliminary injunction against Yucatan in the Commonwealth Court of Pennsylvania, to address violations of the summary cease and desist order and to enforce a lawfully issued subpoena. *See Penn. Sec. Comm'n v. Yucatan Resorts S.A.,* No. 277 M.D. 2003 (Pa. Commw. Ct. June 5, 2003) (Opinion and Order). On June 5, 2003, the court granted the requested relief but left the core legal issue—whether the Yucatan offering is a security—to be resolved in the administrative proceeding. *Id.*

[7] *Available at* http://www.leg.state.co.us/2003a/inetcbill.nsf/fsbcont/1777905CD8404C8187256CC50077A764?Open&file=1311_01.pdf.

troubling attempt to curtail state securities regulation using the Eleventh Circuit's decision as a justification.[8]

These examples illustrate the potentially far-reaching impact that this case may have on state securities regulation and ultimately on public investors. Although the state courts and administrative tribunals that have had occasion to address the Eleventh Circuit's decision thus far have consistently rejected it,[9] the decision of this Court undoubtedly will have a more profound influence on the states' interpretation of the *Howey* test in pending and future cases. To prevent the erosion of state securities regulation, and to restore the SEC's regulatory jurisdiction to full strength, this Court should reverse the decision of the appellate court.

II. THE APPELLATE COURT'S DECISION CONFLICTS WITH THE PLAIN MEANING AND INTENT OF THE SECURITIES LAWS, THE VAST WEIGHT OF DECISIONAL AUTHORITY, AND THE UNDERLYING RATIONALE FOR THE INVESTMENT CONTRACT DEFINITION

The appellate court held that because the returns promised by ETS were at a fixed rate, they could not be classified as a participation in earnings, and therefore could not be

[8] Information about the progress of the bill is available at the following website: http://www.leg.state.co.us/2003a/inetcbill.nsf/Frameset?ReadForm&viewname=3&.

[9] Even where repudiated, the Eleventh Circuit's decision has been watched with interest at the state level. As observed by the Florida Department of Banking and Finance in *Mehl,* "even if the states were bound by the Eleventh Circuit's decision, this decision, as a matter of law, is not final. The SEC has petitioned the [Eleventh Circuit] for rehearing en banc." *Dep't of Banking & Fin. v. Mehl,* No. 02-0526, 2002 WL 31452438, at *4 (Fla. Dep't of Banking & Fin. Oct. 17, 2002) (Final Order).

considered profits for purposes of defining an "investment contract" under *Howey* and *United Hous. Found., Inc. v. Forman,* 421 U.S. 837, 851-53 (1975). *See SEC v. ETS Payphones, Inc.*, 300 F.3d at 1284-85. As an alternative basis for its decision, the court also held that because investors' returns were contractually guaranteed, those returns were not derived from the efforts of others. *Id.* at 1285. Each of these rulings conflicts with the plain meaning and legislative intent of the securities laws, federal and state court precedents, and administrative interpretations that federal and state regulators have been applying for years. The court's rulings furthermore lack a persuasive rationale under the securities laws.

A. The Appellate Court's Interpretation of "Profits" Is Unduly Narrow

1. Statutory Language and Legislative Intent

The appellate court's holding that fixed returns do not satisfy the "profits" test for investment contracts is inconsistent with a statutory analysis. As argued by the SEC in its Petition for a Writ of Certiorari, the words "investment contract," "income," and "profit" all encompass fixed as well as variable rates of return. *See* Petition for a Writ of Certiorari, at 10-11. The appellate court's restrictive interpretation of the term "investment contract" is inconsistent with the plain meaning of the statutory language chosen by Congress.

Legislative intent supports this reading of the statute. Congress intended to define the term "security" broadly in order to eliminate serious abuses in the securities markets. *See, e.g., Reves v. Ernst & Young,* 494 U.S. 56, 60 (1990); *United Hous. Found., Inc. v. Forman,* 421 U.S. at 847-48. The term "investment contract" was added as a catchall provision to ensure that the statute would cover not just the items specifically listed, such as stocks and bonds, but "virtually any instrument that might be sold as an investment." *See Reves,* 494 U.S. at 61; *SEC v. C. M. Joiner Leasing Corp.,* 320 U.S. 344, 351 (1943). Of course, many of the instruments enumerated in the definition of a security involve fixed returns, promises, and even guarantees. *See* 15 U.S.C. §§ 77b(a)(1), 78c(a)(10). As a catchall term, the reference to "investment contract" deserves an interpretation broad enough to include these traditional characteristics of securities, along with features outside the mainstream. *See C. M. Joiner Leasing,* 320 U.S. at 351 ("We cannot read out of the statute these general descriptive designations merely because more specific ones have been used to reach some kinds of documents. Instruments may be included in any of these definitions, as a matter of law, if on their face they answer to the name or description").

In accordance with this legislative intent, this Court has repeatedly declared that the definition of "investment contract" must be construed broadly to effectuate the remedial purposes of the federal securities laws and to protect investors. *See Howey,* 328 U.S. at 299, 301; *see also Tcherepnin v. Knight,* 389 U.S 332, 336 (1967). The appellate court ignored these principles. It seized upon a restrictive interpretation of *Forman* and adopted a "limited meaning" of the word "profits." *See* 300 F.3d at 1284. The resulting dismissal of the SEC's enforcement action against an enterprise that defrauded thousands of investors was at odds with the remedial purposes of the federal securities laws.

2. Federal Court Decisions

The appellate court's decision also conflicts with this Court's original formulation of the investment contract definition, as well as subsequent judicial interpretations of the term. In *Howey,* the Court expressly adopted state court decisions as a guide for defining the term "investment contract," because state courts had developed a definition for that phrase under blue sky laws enacted prior to the federal securities laws. *See Howey,* 328 U.S. at 298. Borrowing directly from state case law, the Court formulated the

definition in terms of "a contract, transaction, or scheme whereby a person invests his money in a common enterprise and is led to expect profits solely from the efforts of the promoter or a third party . . . ." *Id.* at 298-99. As the foundation for this definition, the Court cited seven state cases, three of which involved investment contracts offering fixed returns. *Id* at n.4. *See People v. White,* 12 P.2d 1078, 1079, 1081 (Cal. Dist. Ct. App. 1932) (investment contracts found where promoter offered a $7500 return on $5000 invested in enterprise trading trust deeds, stocks of bankrupt companies, and foreclosure instruments); *Stevens v. Liberty Packing Corp.,* 161 A. 193, 194, 195 (N.J. Ch. 1932) (investment contract found where promoter offered fixed amount per offspring in breeding scheme involving sale and leaseback of rabbits); *Prohaska v. Hemmer-Miller Devel. Co.,* 256 Ill. App. 331 (Ill. Ct. App. 1930) (investment contract found where investor stood to receive up to two-thirds of the price of a land parcel, but not more). Since its early days, then, the concept of an investment contract under federal law has included offerings with fixed returns.[10]

Elsewhere in the *Howey* opinion, the Court used a variety of terms interchangeably to describe an investor's expectations under an investment contract, including "income," "profit," and "financial returns." *See Howey,* 328 U.S. at 298, 300. All of these words encompass fixed as well as variable returns. Removing any doubt on the issue, the Court in *Howey* declared: "It is immaterial whether the enterprise is speculative or non-speculative . . . . The statutory policy of

[10] In *Howey,* the Court observed that the term investment contract had been broadly construed by the states "so as to afford the investing public a full measure of protection" 328 U.S. at 298. The federal securities laws were intended to be even more broadly applied, in light of the "ingenuity and fertility of resources of those dealers in securities who deliberately attempted to avoid" application of blue sky laws. *See SEC v. Crude Oil Corp.*, 93 F.2d 844 (7th Cir. 1937).

affording broad protection to investors is not to be thwarted by unrealistic and irrelevant formulae." *See Howey,* 328 U.S. at 301.

The *Forman* case is not to the contrary. Once again, the Court's choice of words belies the appellate court's narrow interpretation. In *Forman,* the Court repeatedly used terminology that is consistent with fixed as well as variable returns: "income," "profits," and "financial return." *See United Hous. Found., Inc. v. Forman,* 421 U.S. at 851-53. The Court's reference to "participation in earnings" was not an attempt to graft technical distinctions—such as fixed versus variable rates—onto investment contract analysis, but to differentiate the expectations of an investor from those of someone seeking to use or consume a commodity. *See Forman,* 421 U.S. at 852-53. The holding in *Forman* rested squarely on this point, not on notions of fixed or variable returns: "What distinguishes a security transaction—and what is absent here—is an investment where one parts with his money in the hope of receiving profits from the efforts of others, and not where he purchases a commodity for personal consumption or living quarters for personal use." *Id.* at 853. On this basis, the Court held that stock in a non-profit housing cooperative was not an investment contract. In contrast with the *Forman* case, investors in the ETS program were motivated by the lure of profits, not by a desire to acquire telephones. The ETS offerings were investment contracts.[11]

[11] Even if "participation in earnings" were the litmus test for investment contracts, the appellate court's decision would still be incorrect because receiving fixed returns does not preclude one from participating in earnings. To the extent ETS investors actually received fixed monthly yields from pay phone operations, they would have been *participating* in earnings because their returns would have been *paid* from earnings. The appellate court conceded as much: "Of course, the funds generated by the pay phones helped ETS meet its obligations." 300 F.3d at 1285.

The appellate court's interpretation of profits is inconsistent with decisions issued in at least four other federal circuits. In *SEC v. Infinity Group Co.*, 212 F.3d 180 (3d Cir. 2000), *cert. denied*, 532 U.S. 905 (2001), the promoters of an investment trust argued that shares in their program were not investment contracts because they featured a fixed rate of return rather than a rate dependent upon the success of the investments. The Third Circuit flatly rejected this defense, holding that "the definition of a security does not turn on whether the investor receives a variable or fixed rate of return." *Id.* at 189. In *SEC v. SG Ltd.*, 265 F.3d 42 (1st Cir. 2001), the First Circuit had no difficulty finding an "expectation of profits" where a promoter of "virtual companies" on the internet "flatly guaranteed that investments in the shares of the privileged company would be profitable, yielding monthly returns of 10% . . . ." *Id.* at 54.

The Seventh and Ninth Circuit Courts of Appeals also have found offerings to be investment contracts notwithstanding fixed returns. In *United States v. Carman*, 577 F.2d 556 (9th Cir. 1978), the court held that fixed interest on student loans guaranteed by the federal government was nevertheless profit to be derived from the efforts of others. The court focused on the investors' passive role and continuing dependence upon the promoter's sound management and solvency to avoid certain risks of loss. *Id.* at 563. Those risks were deemed "sufficient to bring the transaction within the meaning of a security, even where the anticipated financial gain is fixed." *Id.* As early as 1939, the Seventh Circuit held that an investment in a supposedly novel agricultural operation, promising 30% annual returns, was a security under the early investment contract standard. *See SEC v. Universal Service Ass'n*, 106 F.2d 232, 237-38 (7th Cir. 1939). The court adhered to this result, even though the defendant was

actually insolvent and the promised returns of 30% would have been "paid not from any profit, but from new contributions." *Id.* at 239.[12]

3. State Court Decisions

The appellate court's decision conflicts with the decisions of several state supreme courts.[13] In *State v. Gertsch*, 49 P.3d 392 (Idaho 2002), the defendant sold investments in a vaguely described business enterprise that was, in reality, a classic Ponzi scheme. *Id.* at 394, 397-98. The investors

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[12] Another line of Supreme Court and circuit court cases provides an independent basis for reversing the appellate court's decision at issue here. The Supreme Court has held that the nature of an investment offering may be determined by the representations that promoters have used to sell it to the public. *See SEC v. C.M. Joiner Leasing Corp.*, 320 U.S. 344, 352-53 (1943) (oil leases combined with test drilling services). Until the appellate court issued its decision in this case, the Eleventh Circuit followed this approach. *See SEC v. Unique Financial Concepts*, 196 F.3d 1195 (11th Cir. 1999) (sham investment in foreign currency options evaluated under *Howey* in terms of the promoter's representations). Respondent Edwards quite clearly used the lure of "profits" to offer and sell his pay phone investments, and under this line of cases, he cannot now disavow the status of those offerings as investment contracts. *See* Ex. 15, at 5, 7, 8, 9; Ex. 17, at 4, 5, 8, 9, 10, 11; Ex. 22, at 1,5.

[13] As a threshold matter, state court decisions are relevant in this case for two reasons. First, as discussed in the text above, the term "investment contract" originated in state securities laws enacted during the early 1900's, and was interpreted extensively by state courts before Congress enacted the federal securities laws. *See Howey*, 328 U.S. at 298. For this reason, the Court in *Howey* expressly adopted state judicial interpretations of the term "investment contract" as a guide to its meaning under federal law. *Id.* Second, virtually every state securities law in the country includes a definition of the term "security" that parallels the federal definition by expressly including "investment contracts." Therefore, more recent state court decisions, as well as the early state cases that helped establish the investment contract definition, continue to serve as a useful guide to the meaning of the term.

expected to receive a very high, fixed return of 25% quarterly. *Id.* at 394. The defendant asserted that the transactions resembled bank loans more than capital investments and that the unconditional promise to pay coupled with the fixed return precluded a finding that the investors sought profits. *Id.* at 398. The Idaho Supreme Court, citing principally to the Ninth Circuit's decision in *United States v. Carman*, 577 F.2d 556 (9th Cir. 1978), rejected this defense and held that the transactions were investment contracts. *State v. Gertsch,* 49 P.3d at 399. The court observed that the investors did not perceive the transactions as loans, that they were in fact dependent upon the efforts of the defendant to cultivate new investors, and that despite the promise of a fixed return, they faced substantial risk. *Id.* at 398-99. In light of these facts, the court upheld the jury's finding that "investors sought the return of profits to be made from the entrepreneurial efforts of others." *Id.* The court furthermore noted that the high rate of return could be viewed as a "cap" on the profits expected from the venture." *Id.* at 399. Similarly, while the fixed rate of return promised by ETS may have represented an upper limit on investors' profits, it in no way altered the fundamental character of those profits as derived from the efforts of others.

In *Payable Accounting Corp. v. McKinley,* 667 P.2d 15 (Utah 1983), investors contributed cash and other assets to fund a payroll management business, for which the company promised to pay fixed monthly interest. *Id.* at 16-17. The Supreme Court of Utah held that the arrangement was an investment contract under *Howey* notwithstanding the fixed rate of return:

> The crucial factor is not whether the rate of return is fixed, but whether the "investment transaction is so structured that the money to pay off the investor eventually will be generated by the venture or enterprise". . . . That the investors receive a fixed rate of return does not make this scheme any less an investment contract. The money to pay off the investors is still generated by PAC, and the risk of loss still depends on PAC's managerial skills.

Id. at 19, 21 (quoting *LTV Fed. Credit Union v. UMIC Gov't Sec., Inc.*, 523 F. Supp. 819, 829 n.5 (N.D. Tex. 1981), *aff'd,* 704 F.2d 199 (5th Cir. 1983), *cert. denied,* 464 U.S. 852 (1983)).

In *Gaudina v. Haberman,* 644 P.2d 159 (Wyo. 1982), the defendant offered interests in a trust account that was established to acquire supposedly "top quality" investments such as loans secured by real estate mortgages. The promised rate of return was 14%. The Supreme Court of Wyoming held that this investment offering fit the *Howey* definition of investment contract "like a glove." *Id.* at 164, 166. In *Suave v. K.C. Inc.*, 591 P.2d 1207 (Wash. 1979), the plaintiff invested in a retail appliance leasing business in return for 12% fixed interest payable monthly. *Id.* at 1208. The Supreme Court of Washington held that the arrangement was an investment contract under *Howey,* because even though the investor's return may have been constant, she was still subject to the risk of loss of her entire investment if the management failed to sustain the company's profitability. *Id.* at 1210; *cf. King v. Pope*, 91 S.W.3d 314 (Tenn. 2002) (holding ETS contracts are securities based upon the *Hawaii Markets* analysis).

More recently, trial courts in Colorado and Iowa have held that pay phone sale and leaseback investments, including the ETS contract and a similar version offered by Phoenix telecom, were investment contracts. *See Joseph v. Geier,* No. 01 CV 1151, at 2 (Colo. D. Ct., Denver County, Jan. 30, 2003) (Order on Motions for Summary Judgment) (a fixed rate of return does not take an investment contract out of the definition of a security; to hold otherwise would gut the effectiveness of the Colorado Securities Act in protecting investors against a broad range of investment schemes); *Iowa*

ex rel. Miller v. Pace, Equity No. LA26445, at 17 (Iowa D. Ct., Warren County Sept. 4, 2002), *appeal docketed,* No. 02-1726 (Iowa Oct. 28, 2002) (irrelevant that inducements leading an investor to risk his initial investment are founded on promises of fixed returns rather than a share of profits).[14]

4. Regulatory Interpretation

The appellate court's decision also conflicts with interpretations of the securities laws that federal and state securities regulators have applied for years. Under the principle of deference to administrative interpretation, "considerable weight should be accorded to an executive department's construction of a statutory scheme it is entrusted to administer." *See Chevron, U.S.A., Inc. v. Natural Res. Def. Council, Inc.*, 467 U.S. 837, 844 (1984).

The SEC's position that investment contracts include fixed and guaranteed returns is reflected in the enforcement actions described above, *supra* at Part I.A., and in the authorities discussed in the SEC's Petition for a Writ of Certiorari, at 23-26. State securities regulators also have brought innumerable enforcement actions against ETS, their sales agents, and other companies offering similar sale and leaseback programs. *See, e.g.*, actions discussed *supra* at Part I.A. Thus far, state administrative law judges and commissions have rejected arguments that fixed or guaranteed returns place an investment beyond the reach of *Howey*. For example, in *Dep't of Banking & Fin. v. Mehl,* No. 02-0526, 2002 WL

[14] Since 1939, a minority line of cases has emerged holding that payment of a fixed fee such as interest does not meet the profits test. *See* 12 Joseph C. Long, Blue Sky Law § 2.58 (2002) and cases cited therein. However, these decisions have been viewed as "defective" for two reasons. First, the distinction between dividends and interest is often arbitrary and subject to the control of the promoter. Second, the real focus of the *Howey* profits test is on the motivation of the investor, not the specific nature of the profits or losses of the enterprise. *Id.*

31452438 (Fla. Dep't of Banking & Fin. Oct. 17, 2002) (Final Order), the Florida Department of Banking and Finance rejected the Eleventh Circuit's narrow interpretation of "profits," observing that the Department had characterized the ETS pay phone contracts and similar offerings as securities for ten years. *See id.* at *3; *see also Stigall v. Sec'y of State,* No. EN-18727, at 7-8 (Ga. Comm'r of Sec. Sept. 6, 2002) (Final Decision) (definition of profits is broader than Eleventh Circuit test and includes interest); *Garvin v. Sec'y of State,* No. OSAH-SEC STATE-SECUR-0231234-33-PJ, at 1 (Ga. Off. of Admin. Hgs Aug. 28, 2002) (Order on Reconsideration) ("An offeror may not avoid registration of a security in Georgia merely by establishing a fixed rate of return on the investment"). *But cf. In re Rahaim,* No. E-2000-22, at 5 (Mass. Sec. Div. July 11, 2000) (Memorandum and Order).[15] These interpretations of the securities laws by the regulatory agencies tasked with administering them support reversal of the appellate court's decision.

B. The Appellate Court's Interpretation of the "Efforts of Others" Test Is Plainly Misguided

As an alternative basis for its decision, the appellate court ruled that because investors' returns were contractually guaranteed, those returns were not derived from the efforts of others. *See* 300 F.3d at 1285. This aspect of the appellate court's ruling is illogical and—like the court's principal basis for decision discussed above—irreconcilable with statutory analysis, case law, and regulatory interpretation.

The court's ruling is conceptually flawed because the efforts giving rise to the profits of an enterprise bear no logical relationship to whether or not those profits are guaranteed to an investor. An analysis of the court's decision

[15] The *Rahaim* decision did not rest on the "profits" or "efforts of others" elements of *Howey*, but rather on the ALJ's view that a common enterprise was absent. *See In re Rahaim,* No. E-2000-22, at 4, 9.

reflects this logical defect at every turn. With respect to the statutory language, nothing in the phrase "investment contract" suggests the exclusion of contractually guaranteed returns. Quite the opposite: use of the word "contract" indicates that this category of investment was intended to encompass contractual promises of many varieties, including guarantees. The appellate court offers no authority to support its contrary reading of the statute.

With respect to the case law, courts generally do not focus on guarantees in connection with the "efforts of others" analysis. Decisions from the federal circuit courts have established that the appropriate inquiry under the third element of *Howey* is not whether returns are contractually guaranteed, but "whether the efforts made by those other than the investor are the undeniably significant ones, those essential managerial efforts which affect the failure or success of the enterprise." *See, e.g., SEC v. Glenn W. Turner Enterprises, Inc.*, 474 F.2d 476, 482 (9th Cir. 1973).

Prior to this case, the Eleventh Circuit followed this approach. In *Albanese v. Florida Nat'l Bank of Orlando,* 823 F.2d 408 (11th Cir. 1987), involving an ice machine sale and leaseback scheme, the court found that the promoters retained managerial control over the ice machines and on this basis held that the "efforts of others" test was satisfied. *Id.* at 410-412. With respect to the third prong of *Howey,* the court stated that "Under the precedent of this circuit, the crucial inquiry is the amount of control that the investors retain under their written agreements." *Id.* at 410.

Courts specifically addressing the guarantee issue have rejected the notion that a guarantee negates the "efforts of others" element. In *SEC v. G. Weeks Securities, Inc.*, 678 F.2d 649 (6th Cir. 1982), the Sixth Circuit actually held that a guarantee provision was what made the offering an investment contract. The appellant in *Weeks* offered "standby pair-offs" on GNMA certificates, which essentially involved

buying and selling combinations of GNMA forward contracts. *Id.* at 650. Investors were guaranteed a positive rate of return. *Id.* at 652-53. The court found that the guarantee distinguished the offerings from conventional forward contracts and brought them within the ambit of *Howey*:

> Appellant's scheme, the standby with pair-off, offered an inducement available under neither form of the traditional forward contract, a guaranteed return . . . . G. Weeks Securities could accept the risk of adverse price fluctuations and guarantee a positive return only if they successfully invested the commitment fees deposited by investors. Thus, the standby pair-off would appear to fit precisely the Supreme Court's definition of a security.

Id. at 652-53. Under this reasoning, the ETS guarantee heightened rather than diminished the importance of the promoters' efforts. The investors' entitlement to a fixed and positive return presumably required the company to work ever more strenuously either to manage the pay phones successfully or recruit additional investors in the tradition of a Ponzi scheme.

The Ninth Circuit, in *United States v. Carman,* 577 F.2d 556, 563 (9th Cir. 1978), has expressly rejected the argument that a guaranteed return vitiates the "efforts of others element." There the defendants sold fixed rate, federally guaranteed packages of student loans, along with service contracts. *Id.* at 560, 563-64. Against charges of securities fraud, the defendants argued that their offerings were not securities because returns were in the form of guaranteed fixed interest, which did not depend upon the promoters' efforts. *Id.* at 563. The Ninth Circuit rejected this argument, observing that the investors had a passive role and were in fact dependent upon the "sound management and continued solvency" of the promoter to maintain the guarantee in place

and absorb potential refund liability under the notes. *Id.* Similarly in this case, ETS investors were passive, and they relied upon ETS's continuing efforts to manage the pay phones—or entice additional investors—to pay the promised returns.

State administrative rulings have reached the same result. *See Dep't of Banking & Fin. v. Mehl,* No. 02-0526, 2002 WL 31452438, at *3 (Fla. Dep't of Banking & Fin. Oct. 17, 2002) (Final Order) (ETS guarantee served only to lull the investor into a feeling of security); *Stigall v. Sec'y of State,* No. EN-18727, at 7-8 (Ga. Comm'r of Sec. Sept. 6, 2002) (Final Decision) (contractual guarantee of payment that might be satisfied from capital deemed irrelevant).

C. The Appellate Court's Rulings Have No Rationale Under the Securities Laws

Neither of the appellate court's rulings can be reconciled with the underlying rationale of the securities laws or the cases interpreting them. There is no reason to distinguish investment contracts with fixed or guaranteed returns from those lacking these features. The securities laws were intended to provide investors with certain safeguards because they place their funds at risk. The economic reality is that neither fixed nor guaranteed returns—even from a legitimate business enterprise—can eliminate such risk. Promises may be broken and companies may go bankrupt, as ETS did in this case, from either mismanagement or outright fraud. Very often, in fact, promises of fixed returns and assurances of guaranteed profits are merely sales pitches, not genuine risk-reducing features of an investment. Accordingly, investors require the protections of the securities laws whether or not their returns are fixed or nominally "guaranteed." *Cf. Tcherepnin v. Knight,* 389 U.S. 332, 336 (1967) (in the analysis of investment contracts, "form is to be disregarded over substance" and the emphasis should be on "economic reality"). In terms of the underlying rationale of investor

protection, there is no principled basis for distinguishing investment contracts offering fixed or guaranteed returns from those that do not.

Nor do the facts of this case suggest any basis for treating pay phone promoters differently than other issuers under an investment contract analysis. Nothing about the nature of the ETS contracts and their inherent risks, the investors to whom they were marketed, or the promoters themselves can justify the distinctions drawn by the appellate court. In fact, pay phone sale and leaseback programs represent precisely the type of investment that the securities laws were intended to reach. These products must be subject to continued regulation at the federal and state level for the protection of investors.

CONCLUSION

For the reasons set forth above, the Eleventh Circuit's decision should be reversed.

Respectfully submitted,

MARK J. DAVIS *
Associate Counsel
JOHN R. VEATOR
Deputy General Counsel
STEPHEN W. HALL
Associate Counsel
NORTH AMERICAN SECURITIES ADMINISTRATORS ASSOCIATION, INC.
10 G Street, N.E., Suite 710
Washington, D.C. 20002
(202) 737-0900

* Counsel of Record

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